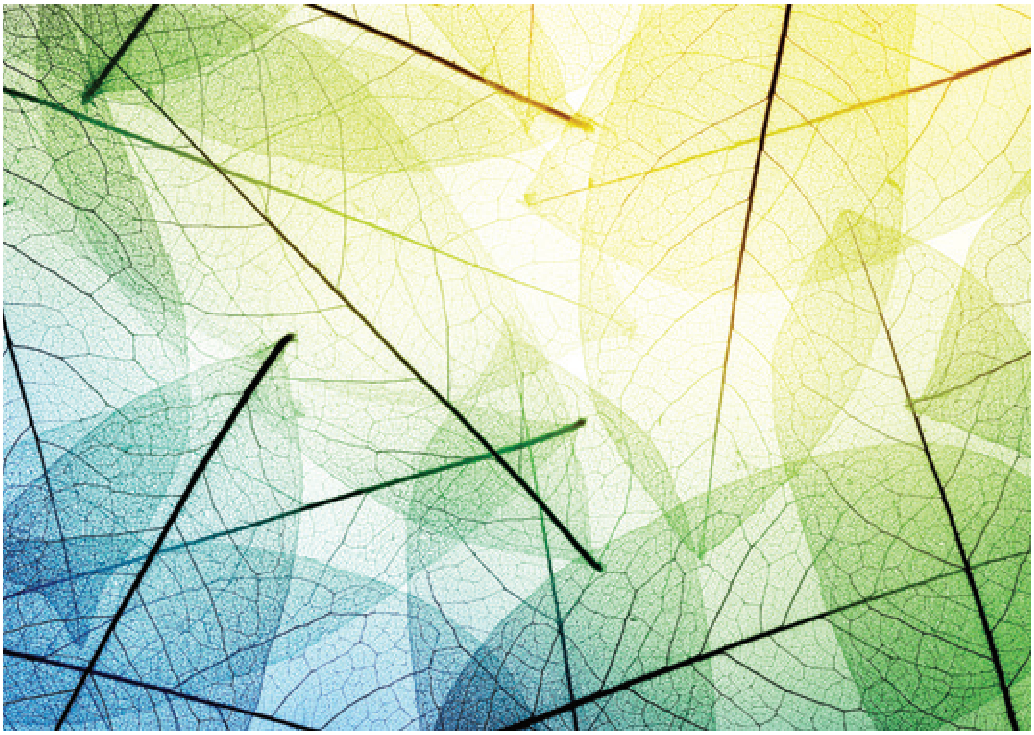


Private credit's green new deal

The asset class has been slower than others when it comes to focusing on environmental, social and governance issues. But, as Rebecca Szkutak discovers, it is working to improve things

Whether private credit firms are bolstering their commitment to environmental, social and governance issues for moral reasons or as a result of pressure from investors, ESG is a growing part of conversations in the asset class. It is also a new phenomenon.

"The focus on ESG and responsible investing increased in private equity several years ago and there has been a delay in private credit," says Paul Johnson, a partner at Stockholm-based European investment fund manager EQT.

The lag can be attributed to private debt's relative youth as an asset class. Private lending is a newer, less mature investing avenue and, with that, come growing pains. Once thought of as a sidekick to private equity, debt lenders were not always expected to examine prospective investments in terms of ESG criteria.

"In general, credit funds are a little bit lagging behind private equity as they maybe think that ESG is just for private equity, which has the control," says Ari Jauho, a partner and chairman at Helsinki-based fund-of-funds manager Certior Capital.

When a private equity investor evaluates a prospective portfolio company, it is typically looking at partial or complete ownership, while debt lenders are performing diligence for a loan that is temporary. For a long time, many credit managers simply did not see the relevance of looking too far into the future.

"Our ability to influence the actual assets is limited to the extent that we don't have economic control of the company," says Alexandre Hökfelt, a director at EQT. "Having said that, as a private debt investor, that doesn't mean we are lax about ESG policies. We take responsible investment seriously and will undertake our own diligence rather than relying on what the sponsor has said."

The mindset that ESG is not a debt issue seems to be diminishing rapidly. Many firms are updating or creating policies, while their limited partners continue to make it a priority.

Jauho says some of the increased urgency can be attributed to investors, who have ESG at the front of their minds and are putting pressure on credit firms to adopt the standards they are accustomed to across other asset classes.

Ambassador network

There is a great deal of variation across the market in where credit firms stand on ESG issues. There are firms, such as EQT, which claim to have been focusing on ESG across their investment strategies for a long time. A few years ago, the Stockholm-based fund manager created an ESG ambassador network comprising representatives from its various service lines who meet every three months to discuss best practice and the latest areas of focus.

"The most important part to begin with is to have a strong vetting strategy," says Hökfelt. "We ask questions such as: which industries do we not want to be affiliated with? What industries do you not want to invest in? The second part of the chain is: are the assets that we potentially invest in reliant on industries we don't want to invest in?"

He says EQT performs its own due diligence on each investment and routinely checks in throughout the term of a loan. When talking to prospective investors, EQT makes sure to walk through its vetting process and provide insight into the types of transactions it is prepared to undertake.

"We will highlight the deals we haven't done and why they aren't an attractive investment," Hökfelt says of the firm's discussions with prospective LPs.

The companies it tends to avoid are those in industries such as gambling, firearms and tobacco. Johnson says avoiding industries such as these is simply "good business" because they are subject to potential tax hikes and bans, which can eat into profits and, ultimately, returns.

Another firm with an eye on ESG issues is Brevet Capital Management, the New York-based credit investment and speciality finance firm with a focus on government.

> *"We are constantly listening to investors to understand where [ESG] is going and how we can be adopting new initiatives"*
>
> **DOUG MONTICCIOLO**
> **Brevet Capital Management**

Chief executive, chief investment officer and founding member Doug Monticciolo says these issues form a cornerstone of its strategy, even though it does not tout itself as an ESG-focused lender.

"We do not actively say that we are ESG investors," Monticciolo says. "However, it is fundamental in how we do what we do. Having a government focus helps us stay focused on being responsible investors."

Monticciolo says the firm, which sources most of its loans through government agencies, looks to build strong relationships with the likes of education or housing departments because they can offer strong flows of ESG-compliant deals. Brevet has had ESG in mind since it was founded in 1998, but ramped up its focus in 2014.

"We are constantly listening to investors to understand where [ESG] is going and how we can be adopting new initiatives," Monticciolo says. "Going back five years or so, it's fascinating how it has evolved. Then, only a handful of investors even asked about ESG and they were typically family offices. Now a sizeable portion of our investors are asking and are looking for us to report [on it]."

Brevet works with advisory firm Institutional Shareholder Services to compile its ESG due diligence on investments, which it then supplies to its investors.

Monticciolo adds that Brevet regularly checks in with its investors to find out

Peeling back the layers of the onion

ESG is a layered system. There are many obvious industries for investors to avoid, such as oil and gas, firearms and tobacco.

However, there are others that seem like solid ESG investments, but which look a little less savoury once you peel through the top layer of due diligence. A business-to-business point-of-sale software company might, for example, appear like a safe bet, but it won't be if its main clients are casinos.

Alexandre Hökfelt, a director at EQT, says that if an investor does not want to put its money into tobacco this will involve more than refusing to fund cigarette companies; it will also mean not investing in any aspect of the manufacturing of tobacco products.

He gives the example of a filter company that is not engaged in any inherently harmful activities and that would not be in violation of EQT's ESG policy. However, if the company were solely creating filters for cigarettes it would form part of the supply chain of a "negative" industry, and would hence be a no-no. Other companies that may seem kosher could have issues with diversity or equal pay.

The deeper a firm looks into an industry the more it sees companies beyond the usual suspects that are not as ESG-compliant as they might originally have appeared.

which ESG issues are of particular concern to them.

"Five years ago, it was very unclear how you could communicate, or what the information was, that people wanted to see [regarding ESG]," Monticciolo says. "Now there are multiple avenues so investors can make their own assessment. It's been great that it is the investing universe that pulled us in."

LP appetite growing

LPs are indeed a big driver for these changes. The *PDI Perspectives 2019* survey showed that 75 percent of LPs that invest in private debt take ESG into consideration when doing so.

Kristine Pelletier, a partner at consultant NEPC, works with endowments and foundations, and says ESG is an increasing topic of conversation for the LPs she works with.

"The area we get the most interest is really about ESG integration," she says. "What is ESG first and foremost and what is it not?"

She adds that with so much information available, and no distinct definition or protocol for the term, a large part of her work involves educating investors about what ESG is, what they should look out for and how to integrate different strategies.

"There are a lot of investing products that are in the [ESG] universe, but that doesn't mean [firms] are labelling their products as ESG," Pelletier says. "I would suggest that there are many institutional investors that hold strategies with strong ESG integration, and they don't even realise it."

NEPC developed a ratings tools to help LPs navigate the different levels of ESG application in the market, as well as within specific fund managers. The firm conducts ESG due diligence on a GP in which an LP might be considering investing, and on the GP's individual products. It then provides rankings on a scale of one to five, with one being the best.

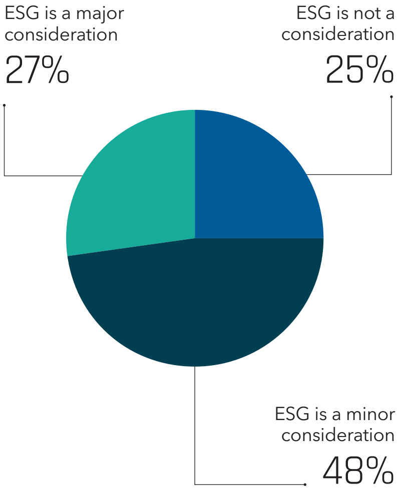
"There is a lot of development on the ESG landscape for investment management firms that have multiple products," Pelletier says. "A firm could be doing a lot of great work, but portfolio managers still have the ability to decide what goes into their product."

Although some LPs have only just started to adopt ESG policies, others have always considered such measures to be a necessity. Certior Capital, like many firms in the Nordic countries, has always taken a rigorous approach to ESG investing.

"There are a lot of investing products that are in the [ESG] universe, but that doesn't mean [firms] are labelling their products as ESG"

KRISTINE PELLETIER
NEPC

More than a quarter of investors surveyed saw ESG as a major consideration



Source: PDI Perspectives 2019

"ESG is pretty important here," Jauho says. "Our client base – they are institutional clients, pension funds – they follow very high ESG standards in general, and that also relates to us. We need to follow high ESG standards as well."

Jauho says Certior performs its due diligence by asking potential fund managers to fill out questionnaires to ensure they meet the required standards. It takes the same approach with co-investments.

The UN-supported Principles of Responsible Investing list currently contains 443 global asset owners (LPs), with 74, or 17 percent, having signed up within the past year. Institutional investors such as the Minnesota State Board of Investment and the Vermont Pension Investment Committee have added their names in 2019.

Although the list does not include every firm in the credit space committed to ESG, it offers a good sample of the types of players making commitments to it.

European pioneers

Firms based in the Nordic countries and elsewhere in Europe are the pioneers, despite private credit lagging behind private equity and other asset classes.

The PRI list includes 344 investment managers (GPs) in the US, covering every segment of investing, compared with more than 900 across Europe. Firms such as Orion Energy Partners and MGG Investment Group signed up to the list earlier this year.

"I think we will continue to see it grow and improve," Pelletier says.

"In the last couple of years, we've seen more investment managers create policies. We will see some pretty significant refinement. We will see it expand and we will see more research and information on performance and results. I don't see it going away."

As the appetite for ESG increases, and lending opportunities grow with it, firms should be keen to join the bandwagon if they have not done so already. Even if they are not seeking to improve their policies or cater to demand from investors, ESG integration will continue to evolve simply because many firms consider it good business to invest in ESG-compliant industries and companies. ■